BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )
)
FISH MACHINERY CORPORATION )

Appearances:

For Appellant: F. E. Lindley and Frank M. Downer, Jr., Attorneys at Law

For Respondent: W. M. Walsh, Assistant Franchise Tax Commissioner; J. J. Arditto, Franchise Tax Counsel

## O P I N I O N

This appeal is made pursuant to Section 19 of the Corporation Income Tax Act of 1937 (Chapter 765, Statutes of 1937, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of the Fish Machinery Corporation to a proposed assessment of additional tax in the amount of $2,155.89 for the taxable year ended December 31, 1939, and pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Chapter 13, Statutes of 1929, as amended) from his action in overruling the protest of the Corporation to the proposed assessment of a minimum franchise tax for the taxable years ended December 31, 1940, and 1941, in the amount of $25.00 for each year.

In 1923, two individuals obtained patent rights on a machine designed to remove bones from fish. The machine as patented, however, required further development before its commercial possibilities could be realized, and to finance this work these individuals sold interests to others in the patent, as well as in subsequent patents, patent applications and prospective patents relating to the machine. Differences arose in 1929 between the parties interested in the machine and patents, hereinafter referred to as interest owners, and litigation resulting therefrom was compromised by an agreement providing for the vesting of legal title to all patent rights in one name. It is not disputed that placing legal title in one name was motivate purely by a desire to prevent the sale or licensing of any of the patent rights other than by all the interested parties as a group The Appellant was organized, accordingly, to take the title to the patents. Although a permit to issue stock was obtained, none was issued thereunder. No stockholders meetings were held, except the first meeting of the incorporators. No directors were elected and no directors meetings were held after the first organizational meeting. The corporation neither paid out nor received any money and did not perform any other functions prior to 1939. All affairs were conducted and paid for by the interest

owners. Subsequently, the corporate franchise was forfeited for failure to pay the franchise tax.

In 1939, the Atlantic Coast Fisheries Company exercised an option which had been obtained from the principal interest owners for the purpose of purchasing the patent rights. The consideration was primarily stock in the purchasing corporation, plus $10,000 in cash. The purchaser required transfers from all the interest owners and the stock received in consideration for the sale was transferred directly to them. On the purchaser's insistence that the Appellant transfer what title it had to these patents, the corporate franchise was revived, a new permit to issue stock obtained and shares were issued and deposited in escrow. The cash consideration was deposited to the account of the corporation to cover expenses and any taxes prior to liquidation. The interest owners were required by the Commissioner to include the value of this stock and their share of the money in their returns of income under the California Personal Income Tax Act.

The Commissioner's proposed assessment of $2,155.89 for 1939 is based on the theory that the Appellant realized income in that year from the sale of the patent rights, it being his view that the corporation should be considered an entity separate and apart from the individuals who had owned the patent rights prior to its formation in 1929. He contends that since the corporate form had been utilized by the interest owners,, the Appellant realized income from the sale of the patent rights and, accordingly, incurred tax liability. The Appellant contends that since it performed no normal corporate activities, received no profits and conducted no business and had been formed merely to hold naked title to the patent rights, it should not be considered a separate entity for corporate income tax purposes.

The general rule is that a corporation and its shareholders are distinct entities unless such a concept otherwise presents an obstacle to the due enforcement of public or private rights. Such is also the rule for taxation purposes. Miller v. McColgan, 17 Cal. 2d 432, New Colonial Ice Co, v. Helvering 292 U.S. 435. There is a tendency in tax cases however to be less strict in separating the corporate entity from the individuals who have formed the corporation on the theory that taxation is more concerned with substance than with form. North Jersey Title Ins. Co. v. Commissioner, 84 F. 2d 898, 901. The test presently followed in the federal courts is that if incorporation is undertaken for a purpose which "is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable 'entity." Moline Properties v. Commissioner, 319 U.S. 436,439. In the Moline case, the United States Supreme Court refused to ignore the corporate entity of a one-man corporation where that corporation had conducted business activities consisting of the assuming of certain obligations of the stockholder, the defending and instituting of court actions, and the leasing and mortgaging of its property. The court cited without disapproval, however, several Federal Circuit Court decisions in which the separate corporate existence was disregarded for the tax benefit of the individuals

who had formed the corporations. It is also noted that there are exceptions to the strict rule that the use of the corporate device ordinarily requires that tax liability attach to the corporation.

The test of whether the corporation has engaged in business activity has subsequently been applied by the federal courts. Thus, in Poymer v. Commissioner, 150 Fed. 2d 334, it was held that a corporation formed to hold bare legal title to property formerly held in partnership, for the purpose of protecting the partners' interest against the creditors of one partner, was not sufficiently engaged in business activity to require it to be taxed separately from the individual owners. Another corporation formed by the same partners for the same purpose was held a separate taxable entity because loans had been negotiated in the corporate name. It appears that the Appellant carried on no more business activity than the corporation held not to be a taxable entity in the Poymer case, It was formed for a like purpose of protecting the owners by holding bare legal title to property and engaged in no other activity. See also Herringer Bros. & Son v. United States, 53 F. Supp, 716, appeal dismissed 142 F. 2d 465; Cf. National Investors v. Hoey, 144 F. 2d 466.

We are not aware of any California decisions involving the question presented here. The California Supreme Court has allowed the separate existence of a corporation to be disregarded where it was formed with the purpose of evading the tax laws. H.A.S. Loan Service v. McColgan, 21 Cal, 2d 518. But most of the cases deal only with general corporation law and are concerned with disregarding the separate entity to prevent fraud or abuse of the corporate privilege. Clark v. Millsap, 197 Cal. 765; Shea v. Leonis 14 Cal. 2d 666. Although in many of such cases it is stated that fraud or bad faith must be shown before the corporate entity will be disregarded, other cases have required only that the recognition of separate corporate existence produce an inequitable result. Watson v. Commonwealth, 8 Cal. 2d 61. Stark v. Coker, 20 Cal. 2d 839. At least one decision has allowed the corporate form to be ignored for the benefit of the substantial owners. In re St. Clair Estate Co., 66 Cal. App. 2d 964.

There appears to be no reason, accordingly, why California should not follow the federal cases and disregard the corporate entity in favor of a taxpayer where the corporation is a dummy not engaged in any corporate business activity but merely holding bare legal title to property as an instrumentality of the shareholders.

The Commissioner also determined that the Appellant should be assessed the minimum franchise tax for the taxable years ended December 31, 1940, and December 31, 1941. While the Appellant has not conceded the validity of these assessments, in view of the fact that the amounts involved are small, it is not contesting them.

Appeal of Fish Machinery Corporation

## O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED,

(a) that the action of Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protest of the Fish Machinery Corporation to a proposed assessment of additional corporation income tax in the amount of $2,155.89 for the taxable year ended December 31, 1939, pursuant to Chapter 765, Statutes of 1937, as amended, be and the same is hereby reversed; said ruling is hereby set aside and the said Commissioner is hereby directed to proceed in conformity with this order;

(b) that the action of the said Commissioner in overruling the protests of said Corporation to proposed assessments of a minimum franchise tax for the taxable years ended December 31, 1940, and 1941, in the amount of $25.00 for each year be and the same is hereby sustained.

Done at Sacramento, California, this 20th day of February, 1947, by the State Board of Equalization.

Wm. G. Bonelli, Chairman
Geo. R. Reilly, Member
J. H. Quinn, Member
Jerrold L. Seawell, Member

ATTEST: Dixwell L. Pierce, Secretary